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Will Motive, Opportunity or Recklessness No Longer Constitute Scienter for Fraud? A Survey of Recent Federal District Court Decisions After the Enactment of the 1995 Private Securities Litigation Reform Act

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I. INTRODUCTION

Following the enactment of the Private Securities Litigation Reform Act of 1995[1] (Reform Act), recent federal district court decisions are causing an uproar in the area of securities fraud litigation. The Reform Act was passed on December 22, 1995, when Congress overrode President Clinton's veto.[2] The Reform Act imposes significant new limitations and requirements on private securities fraud

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1. Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (codified as amended in scattered sections of 15 U.S.C.).

2. *See* Bruce G. Vanyo et al., *The Pleading Standard of the Private Securities Litigation Reform Act of 1995*, *in* SECURITIES LITIGATION 1015, at 74 (PLI Corp. Law & Practice Course Handbook Series No. B4-7199, 1997). The following explanation accompanied President Clinton's veto:

> I am prepared to support the high pleading standard of the [Second Circuit]–the highest pleading standard of any Federal circuit court. But the conferees make crystal clear in the Statement of Managers their intent to raise the standard even beyond that level. I am not prepared to accept that.
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> The conferees deleted an amendment offered by Senator Specter and adopted by the Senate that specifically incorporated Second Circuit case law with respect to pleading a claim of fraud. Then they specifically indicated that they were *not* adopting Second Circuit case law but instead intended to "strengthen" the existing pleading requirements of the Second Circuit. All this shows that the conferees meant to erect a higher barrier to bringing suit than any now existing . . . .

Id. (quoting PRESIDENT OF THE UNITED STATES WILLIAM CLINTON, VETO OF H.R. 1058, H.R. DOC. NO. 104-150, at 1 (1995)). *See generally* Martha L. Cochran et al., *The Private Securities Litigation Reform Act-Overview, Summary and New Developments*, *in* 28TH ANNUAL INSTITUTE ON SECURITIES LITIGATION 962, at 185-88 (PLI Corp. Law & Practice Course Handbook Series No. B4-7141, 1996) (providing an overview describing the efforts and events which culminated in the enactment of the Reform Act).

actions brought under the Securities Act of 1933 (Securities Act) and the Securities Exchange Act of 1934 (Exchange Act).[3] Specifically, the Reform Act calls into question the scienter element that plaintiffs must meet in order to bring a private action under section 10(b) of the Exchange Act[4] and under the Securities and Exchange Commission (SEC) rule 10b-5.[5] The Supreme Court defined scienter as "a mental state embracing intent to deceive, manipulate, or defraud."[6]

The Reform Act amends the Exchange Act by adding that "the complaint shall state with particularity *all facts* on which that belief is formed"[7] and "state with particularity facts giving rise to a *strong inference* that the defendant acted with the required state of mind."[8] These code provisions are applicable to all securities fraud cases filed after the enactment of the Reform Act.[9]

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3. *See generally* Cochran et al., *supra* note 2, at 189-92 (summarizing the Reform Act's major provisions); John L. Latham & Jenna L. Fruechtenicht, *Securities Regulation*, 48 MERCER L. REV. 1677 (1997) (providing a broad overview of securities regulation).

4. 15 U.S.C. § 78j(b). Section 10(b) makes it unlawful for any person "[t]o use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [SEC] may prescribe." *See* Rehm v. Eagle Fin. Corp., 954 F. Supp. 1246, 1250 (N.D. Ill. 1997) (quoting 15 U.S.C. § 78j(b)).

5. Securities Exchange Act of 1934, 17 C.F.R. § 240.10b-5 (1997).

6. *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193-94 n.12 (1976) (holding that in the absence of activities involving scienter, an action under section 10(b) of the Exchange Act and rule 10b-5 will not lie). *See generally* William H. Kuehnle, *On Scienter, Knowledge, and Recklessness Under the Federal Securities Laws*, 34 HOUS. L. REV. 121 (1997) (providing an overview of the history and application of scienter).

7. *See* Private Securities Litigation Reform Act of 1995 § 104, 15 U.S.C. § 78u-4(b)(1) (1997) (emphasis added). Section 78u-4(b)(1) states in pertinent part that "the complaint shall specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed." *Id. See generally* William S. Lerach & Eric Alan Isaacson, *Pleading Scienter Under Section 21D(b)(2) of the Securities Exchange Act of 1934: Motive, Opportunity, Recklessness, and the Private Securities Litigation Reform Act of 1995*, 33 SAN DIEGO L. REV. 893 (1996) (providing a historical and structural examination of § 21D(b)).

8. Private Securities Litigation Reform Act § 104 (emphasis added). In its entirety, section 78u-4(b)(2) provides:

> In any private action arising under this chapter in which the plaintiff may recover money damages only on proof that the defendant acted with a particular state of mind, the complaint shall, with respect to each act or omission alleged to violate this chapter, state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.

Id. See generally Elliot J. Weiss, *The New Securities Fraud Pleading Requirement: Speed Bump or Road Block?*, 38 ARIZ. L. REV. 675 (1996) (concluding that § 21D(b)(2) presents more of a speed bump than a road block for plaintiffs pursuing open market fraud claims because the effectiveness of this provision is dependant upon each court's own interpretation of the pleading standard).

9. *See* Cochran et al., *supra* note 2, at 192.

The Reform Act was prompted by the need and goal of "curbing frivolous securities class action litigation."[10] In 1996, SEC Chairman Arthur Levitt explained in his own words why private securities litigation reform was desirable:

> It doesn't help investors or the markets if we're too accommodating of those who think that they should be able at the drop of a hat–or the drop of a stock–to file a lawsuit immediately, hoping to wring out a profitable settlement, whether or not the company or its officers did anything wrong.
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> . . .
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> . . . So it was unusual for an SEC Chairman to acknowledge that the litigation system required reform. But the pendulum had swung too far toward plaintiffs, and it needed to be brought into better balance.[11]

Before the enactment of the Reform Act, "plaintiffs were permitted to aver scienter generally."[12] Now, with the adoption of the Reform Act, plaintiffs are required to meet the "strong inference" standard to prove that defendants acted with the required state of mind.[13] It is generally agreed that this strong inference standard reflects the Second Circuit's interpretation of scienter for alleging securities fraud under section 10(b) of the Exchange Act.[14] The Second Circuit requires a plaintiff to "allege specific facts that either (1) 'constitut[e] circumstantial evidence of either reckless or conscious behavior,' or (2) 'establish a motive to commit fraud and an opportunity to do so.'"[15] However, when the Reform Act

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10. *See Securities Litigation Abuses: Concerning the Impact of the Private Securities Litigation Reform Act of 1995 Before the Subcomm. on Sec. of the Senate Comm. on Banking, Hous. and Urban Affairs*, 105th Cong. (1997) (statement of Arthur Levitt, Chairman, SEC), *available in* 1997 WL 11235194 [hereinafter *Levitt*].

11. Arthur Levitt, *"Final Thoughts on Litigation Reform" Remarks by Chairman Arthur Levitt United States Securities and Exchange Commission 23rd Annual Securities Regulation Institute San Diego, California January 24, 1996*, 33 SAN DIEGO L. REV. 835, 837-38 (1996).

12. *See In re* Silicon Graphics, Inc. Sec. Litig., 970 F. Supp. 746, 754 (N.D. Cal. 1997) [hereinafter *Silicon Graphics II*].

13. *See* Friedberg v. Discreet Logic Inc., 959 F. Supp. 42, 43 (D. Mass. 1997) (citing 15 U.S.C. § 78u-4(b)(2)).

14. *See* H.R. CONF. REP. NO. 104-369, at 37 (1995), *reprinted in* 1995 U.S.C.C.A.N. 736.

15. *See In re* Silicon Graphics, Inc. Sec. Litig., No. C96-0393, 1996 WL 664639, at *5 (N.D. Cal. Sept. 25, 1996) [hereinafter *Silicon Graphics I*] (quoting *In re* Time Warner, Inc. Sec. Litig., 9 F.3d 259, 269 (2d Cir. 1993)). "To allege conscious misbehavior or recklessness, the Complaint must link the misleading statement with facts that give rise to an inference that the speaker had a basis for knowing it was false." Shahzad v. H.J. Meyers & Co., No. 95 Civ. 6196 (DAB), 1997 WL 47817, at *7 (S.D.N.Y. Feb. 6, 1997) (adopting both prongs of the Second Circuit's standard) (citing Shields v. Citytrust Bancorp, Inc., 25 F.3d 1124, 1129 (2d Cir. 1994); Pollack v. Laidlaw Holdings, Inc., No. 90 Civ. 5788, 1995 WL 261518, at *2 (S.D.N.Y. May 3, 1995)). "Motive requires a showing of 'concrete benefits that could be realized by one or more of the false statements . . . alleged' and opportunity is shown by 'the means and likely prospect of achieving concrete benefits by the means alleged.'" *Id.*

was enacted, it could be argued that Congress did not whole-heartedly adopt the Second Circuit's pleading standard because any language referring to motive, opportunity, and recklessness was left out.[16]

The distinct opinions reached by federal district courts reflect the ambiguity of the Reform Act as the courts attempt to balance the Reform Act's legislative history, language and purpose against established precedent.[17] Significant splits have been observed among federal district courts interpreting key Reform Act provisions as some courts have heightened the pleading standard needed to bring a private securities fraud action and others have not.[18] According to congressional testimony by SEC Chairman Levitt, the courts are divided over the proper interpretation of the Reform Act's language because each court takes a distinct view of the Reform Act's legislative history.[19] The most interesting aspect about the decisions raising the standard for pleading private securities fraud is that the law is well established in each of the ten federal appellate courts which have considered this issue.[20] For instance, in each federal circuit, the "proof of recklessness satisfies the scienter requirement and can establish liability under the anti-fraud provision of section 10(b) of the Exchange Act."[21] Some views of recklessness include holding "plaintiffs to a higher standard of pleading and proof by requiring the reckless conduct to be of such degree that it can serve as evidence of knowing or intentional deception, manipulation or fraud."[22] Other courts have held that "pleading and proving unqualified reckless conduct will suffice."[23]

The Supreme Court has yet to rule on the appropriate pleading standard for fraud following the enactment of the Reform Act, and until the Supreme Court does, it is likely that federal district courts will continue to apply the Reform Act

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(quoting *Shields*, 25 F.3d at 1129; *Pollack*, 1995 WL 261518, at *2).

16. *See Silicon Graphics II*, 970 F. Supp. at 756.

17. *See generally Levitt, supra* note 10, at *17 (stating that "the courts are divided over the proper interpretation of this language").

18. *See Securities Litigation Abuses: Ten Things We Know and Ten Things We Don't Know About the Private Securities Litigation Reform Act of 1995 Before the Subcomm. on Sec. of the Senate Comm. on Banking, Hous., and Urban Affairs*, 105th Cong. (1997) (joint written testimony of Joseph A. Grundfest and Michael A. Perino), *available in* 1997 WL 11235196 [hereinafter *Ten Things We Know*].

19. *See Levitt, supra* note 10. At least eight courts have adopted the traditional Second Circuit standard allowing "plaintiffs to plead facts giving rise to a strong inference that the defendants acted either knowingly or recklessly, or that the defendants had a motive and opportunity to commit the fraud." *See id.* A more stringent standard has been adopted by at least five other courts, requiring that "only conscious misrepresentations or omissions" or "deliberate recklessness" satisfy the Reform Act's pleading standard. *See id.*

20. *See id.*

21. *See id.* The Supreme Court found in *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976), that a section 10(b) claim requires a showing of scienter which cannot be supported by negligence alone. *See* Dennis J. Block & Jonathan M. Hoff, *Scienter Requirement Under Securities Litigation Reform*, N.Y.L.J., July 17, 1997, at 5. Following *Hochfelder*, almost every court of appeals has determined that some form of "recklessness" may satisfy the required state of mind requirement. *See id.*

22. *See* Block & Hoff, *supra* note 21, at 5.

23. *Id.*

as they see fit.[24] By analyzing recent federal district court decisions, this Comment will focus on the justifications for the decisions made by federal district courts and whether some federal district courts have gone too far in their interpretations of the Reform Act by holding that motive, opportunity, or recklessness no longer constitute scienter for fraud.

II. THE IMPORTANCE OF THE PLEADING STANDARD

A Congressional Conference Committee Report that accompanied the Reform Act noted the seriousness of naming a party in a civil suit for fraud, which represents the reason why rule 9(b) of the Federal Rules of Civil Procedure[25] requires plaintiffs to plead allegations of fraud with "particularity."[26] However, the Committee observed that this pleading rule "has not prevented the abuse of the securities laws by private litigants."[27] Additionally, the courts of appeals have interpreted rule 9(b) in conflicting ways, resulting in the application of distinct and differing standards.[28] The Committee Report further commented that the House and Senate hearings on securities litigation reform recognized these inconsistencies and noted the need to establish "uniform and more stringent pleading requirements" in order to curtail the filing of frivolous lawsuits.[29] When choosing the language of the Reform Act, the Conference Committee used the pleading standard of the Second Circuit as a foundation because this standard specifically incorporated rule

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24. In *Miller v. Provenz*, 102 F.3d 1478 (9th Cir. 1996), *cert. denied*, 118 S. Ct. 48 (1997), the Supreme Court had an opportunity to "resolve the perennial question of what constitutes scienter sufficient to support liability under section 10(b) of the 1934 Securities Exchange Act," but certiorari was denied when the Supreme Court convened for the 1997-98 term. *See US Supreme Court: Justices Face Variety of Securities Issues as 1997-98 Term Convenes*, BNA SEC. L. DAILY, Sept. 29, 1997, at D3. In *Miller*, stock purchasers brought a class action against a computer company and its officers for securities fraud. *See id.* The Northern District Court of California granted the company's motion for summary judgment, and the Ninth Circuit Court of Appeals reversed in part, holding that a triable issue as to scienter existed. *See id.* In their petition for review, the defendants "urged that recklessness—especially objective recklessness, which approaches mere negligence—does not satisfy the plain language of section 10(b). It is completely inconsistent with the statute's legislative history." *Id.* The defendants contended that this case warranted Supreme Court review because lower courts were "in disarray" as to what constitutes scienter for section 10(b) actions. *See id.* In their opposition brief, plaintiffs stated that "[a]lthough the [Reform Act] changed the law governing pleading and proof of scienter in securities cases . . . (it) does not govern this case." *Id.* (alterations in original). *Miller* was denied certiorari review on October 6, 1997. *See id.*

25. FED. R. CIV. P. 9(b).

26. *See* H.R. CONF. REP. NO. 104-369, at 37 (1995), *reprinted in* 1995 U.S.C.C.A.N. 736.

27. *See id.*

28. *See id.*

29. *See id.*

9(b)'s notion of pleading with particularity.[30] The Second Circuit's standard is regarded as the most stringent pleading standard because "the plaintiff must state facts with particularity, and in turn, these facts must give rise to a 'strong inference' of the defendant's fraudulent intent."[31] The Committee stated that "[b]ecause the Conference Committee intends to strengthen existing pleading requirements, it does not intend to codify the Second Circuit's case law interpreting this pleading standard."[32] Additionally, the report stated that "[f]or this reason, the Conference Report chose not to include in the pleading standard certain language relating to motive, opportunity, or recklessness."[33] Furthermore, the Committee noted that the plaintiffs must specifically plead with particularity each statement they allege to be misleading, explain in detail the reason or reasons why the statement is misleading, and if the plaintiffs base an allegation on information and belief, then they must plead with particularity those facts in their possession that influenced their belief.[34]

Although the Reform Act's legislative history suggests Congress intended a more exact pleading standard for scienter, the Reform Act does not define the required state of mind or specify the standard by which to measure allegations of scienter.[35] Consequently, courts differ in their interpretations of "both the conduct necessary to satisfy the scienter element of section 10(b) as well as the standard for pleading fraud."[36] As a result, there is some ambiguity as to whether the pleading standard is more stringent than the Second Circuit's standard because the Reform Act's language is so vague.[37] This ambiguity results in "inconsistent judicial application of the Reform Act."[38]

III. A SURVEY OF RECENT POST-REFORM ACT OPINIONS BY FEDERAL DISTRICT COURTS

The federal district courts that have been most active in rendering post-Reform Act decisions are the First, Second, Third, Fifth, Sixth, Seventh, Ninth and Eleventh Circuits.[39] For the most part, the opinions interpreting the Reform Act can be categorized into one of three approaches.[40] The first approach heightens the

30. *See id.*
31. *See id.*
32. *Id.*
33. *Id.* at 44.
34. *See id.* at 36.
35. *See* Block & Hoff, *supra* note 21, at 5.
36. *See id.*
37. *See id.*
38. *See id.*
39. *See, e.g.*, William S. Lerach, *"Private Securities Litigation Reform Act of 1995—20 Months Later," Securities Class Action Litigation Under the Private Securities Litigation Reform Act, "A Brave New World," in* SECURITIES LITIGATION 1015, at 40-41 (PLI Corp. Law & Practice Course Handbook Series No. B4-7199, 1997) (listing cases from various circuits that adopt the Second Circuit's pleading standard).
40. *See* Block & Hoff, *supra* note 21, at 5.

pleading standard for fraud by rejecting recklessness, which prior to the Reform Act, had been an established and accepted standard for scienter.[41] Instead, plaintiffs are required "to plead and prove that the defendant acted with a deliberate and conscious intent to commit fraud."[42] The second approach essentially adopts the standard of the Second Circuit by holding that reckless conduct can establish substantive law scienter and that the pleading standard under the Reform Act is satisfied by allegations of the "defendant's 'motive and opportunity' to commit fraud."[43] The third approach keeps the standard of the Second Circuit in place by permitting a showing of recklessness to meet the Reform Act's scienter substantive law requirement.[44] However, this approach asserts that allegations based solely on the defendant's motive and opportunity to commit fraud do not satisfy the Reform Act's heightened "strong inference" pleading standard which requires a showing of conscious behavior.[45]

The SEC has stated that it will intervene in any decisions holding that allegations of recklessness do not satisfy the pleading requirements for private securities fraud because these decisions are contrary to "established case law upholding recklessness as a basis for liability."[46] To effectively enforce securities laws, SEC Chairman Levitt has stated that the recklessness standard is "absolutely fundamental" to the work of the SEC.[47] Chairman Levitt further expressed that "[i]f we were to lose the recklessness standard, in my judgment, we would leave substantial numbers of the investing public naked to attack by fraudsters and schemers."[48]

A. The Ninth Circuit

The Ninth Circuit provides the most active forum for securities litigation.[49] This Comment will first review federal district court decisions made in the Ninth Circuit because these decisions have received the most attention from other

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41. *See id.*
42. *See id.*
43. *See id.*
44. *See id.*
45. *See id.*
46. *See Levitt, supra* note 10.
47. *See Litigation Reform: Levitt Eschews 'Broad-Based Preemption' of Private Securities Actions Under State Law*, BNA SEC. L. DAILY, Oct. 22, 1997, at D2.
48. *Id.*
49. *See* Joseph A. Grundfest & Michael A. Perino, *Securities Litigation Reform: The First Year's Experience*, § VII (last modified July 23, 1997) <http://securities.stanford.edu/report/pslra_yr1/index.html>. The Ninth Circuit accounted for 27.6% of all securities law suits filed between December 22, 1995 and December 31, 1996. *See id.*

circuits, as well as the SEC. With respect to the pleading standard for securities fraud, other circuits and interested parties frequently cite to decisions rendered by the federal district courts within the Ninth Circuit.[50] Additionally, for the first time, with respect to this issue, one particular Ninth Circuit decision prompted the SEC to take a strong stance by filing an amicus curiae brief.[51]

Marksman Partners, L.P. v. Chantal Pharmaceutical Corp.[52] was the first Ninth Circuit federal district court case to deal with the issue of whether the Reform Act heightens the pleading standard for securities fraud.[53] In *Marksman*, the court read the legislative history of the Reform Act and concluded that the Reform Act did not eradicate the motive and opportunity test for establishing scienter.[54] The court confronted and addressed the controversial language in footnote twenty-three of the Conference Committee Report.[55] Footnote twenty-three suggests that Congress chose not to codify the Second Circuit's standard because it intended to strengthen the pleading requirement.[56] The *Marksman* court recognized the implications of the language in footnote twenty-three; however, the court noted that this language did not "indicate that Congress chose to specifically disapprove the motive and opportunity test."[57] The court further commented that it had "little doubt that when Congress wishes to supplant a judicially-created rule it knows how to do so explicitly, and in the body of the statute."[58] As noted by one commentator, the *Marksman* court found "the 'motive and opportunity' test to be consistent with the Reform Act's purposes, relatively invulnerable to abuse, and to represent a tested and proven rule that courts outside the Second Circuit could also easily adopt."[59]

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50. *See* Vanyo et al., *supra* note 2, at 91; *see also CA Judge May Reconsider Pleading Standard for Securities Fraud: In re Silicon Graphics Securities Litigation,* ANDREWS SEC. & COMMODITIES LITIG. REP., May 14, 1997.

51. *See SEC Asks Judge to Take Another Look at Silicon Fraud Ruling: In re Silicon Graphics Securities Litigation,* ANDREWS SEC. & COMMODITIES LITIG. REP., Feb. 12, 1997, at 8.

52. 927 F. Supp. 1297 (C.D. Cal. 1996).

53. *See id.* at 1310.

54. *See id.* at 1311-12. In a footnote, the *Marksman* court also refuted the defendants' argument that the Reform Act abolished mere recklessness as a form of scienter. *See id.* at 1309 n.9. The court believed that the Conference Committee Report accompanying the Reform Act suggested that Congress did not intend to change the existing state of mind requirements, including recklessness. *See id.* The court stated that unless the recklessness standard was specifically abrogated, it remained viable. *See id.* The court acknowledged the ambivalent positions legislators took with respect to the recklessness standard, resulting in Congress' reluctance to make a final, statutory determination as to whether recklessness establishes scienter. *See id.* However, the court found that recklessness remained a viable form of scienter despite the Reform Act's text and legislative history because "legislative silence" does not allow a court to determine that recklessness no longer constitutes scienter. *See id.*

55. See *id.* at 1311.

56. *See id.*

57. *See id.*

58. *See id.*

59. *See* John C. Coffee, Jr., *First Anniversary: PSLRA of 1995*, N.Y.L.J., Jan. 20, 1997, at 5.

Although *Marksman* was the first district court in the Ninth Circuit to address the issue of whether the Reform Act heightens the pleading standard for securities fraud, *Marksman* has not been followed in all Ninth Circuit decisions.[60] The two *Silicon Graphics* cases, which were decided after *Marksman*, address the "same question in precisely the reverse light."[61] The divergent views expressed amongst these cases within the same circuit illustrate the "inherent ambiguity of the legislative record" as clear answers for interpreting the strong inference standard implemented under the Reform Act.[62]

The two *Silicon Graphics* cases are particularly noteworthy Ninth Circuit decisions that raise the pleading standard for private securities fraud, ultimately finding that "motive, opportunity, and non-deliberate recklessness" are, in and of themselves, insufficient to support a finding of scienter unless the totality of the circumstances creates a strong inference of fraud.[63] The opinion in *Silicon Graphics II* builds on the opinion stated in *Silicon Graphics I*.[64] In deciding each case, Judge Smith paid close attention to the Reform Act's language, legislative history, and policy goals of discouraging frivolous securities fraud litigation.[65] Those opposing the *Silicon Graphics*' holdings question the right of a federal district court to redefine scienter as conscious knowledge when almost every other

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60. *But see In re* Oak Tech. Sec. Litig., No. 96-20552 SW, 1997 WL 448168, at *1 (N.D. Cal. July 1, 1997) (upholding *Marksman* by applying the standard of the Second Circuit).

61. *See* Coffee, *supra* note 59, at 5 (discussing the *Silicon Graphics* court's holding relying upon its view that Congress intended to adapt a stricter rule than that of the Second Circuit).

62. *See* Zeid v. Kimberley, 973 F. Supp. 910, 917 (N.D. Cal. 1997). The *Zeid* court held that the plaintiffs must allege specific facts showing the defendants' motive and opportunity to commit fraud or "specific facts constituting circumstantial evidence of conscious behavior or recklessness." *See id.* at 918. The *Zeid* court found that when the complaint is based on "investigation of counsel" rather than "information and belief," the plaintiffs are not required to state with particularity all facts upon which their beliefs are formed. *See id.* at 915. The court held, however, that plaintiffs must still meet the other strict requirements of the Reform Act and rule 9(b) when the complaint is not based on information or belief. *See id.* Specifically, the court held that the "[p]laintiffs cannot rely on conclusory allegations or tenuous inferences but instead, must allege with particularity: (1) each statement, (2) why each statement is false, and (3) as to each statement, facts giving rise to a strong inference that Defendants acted with scienter." *Id.* The court dismissed the plaintiffs' 104 page complaint with prejudice because the plaintiffs failed to plead each allegation with particularity. *See id.* at 925. Scholarly testimony before the Congressional Committee on securities reform noted that *Zeid*'s "all facts" pleading requirement is a point of major uncertainty under the Reform Act. *See Ten Things We Know*, *supra* note 18. *Zeid* is currently on appeal to the Ninth Circuit. *See id.* The SEC filed an amicus curiae brief in October 1997. *See* Brief of the Securities and Exchange Commission, Amicus Curiae, *Zeid*. (No. 97-16070) (last modified Dec. 3, 1997) <http://securities.stanford.edu/briefs/firefox/9716070/sec.html>.

63. *See Silicon Graphics II*, 970 F. Supp. at 766.

64. *See* Edward Brodsky, *Scienter Under the 1995 Reform Act*, N.Y.L.J., July 9, 1997, at 3.

65. *See id.*

circuit that has been faced with this issue has found recklessness to be sufficient.[66] Undoubtedly, *Silicon Graphics* court finds ample support for its decisions in the Reform Act's language, legislative history, and public policy goals.[67] The well-reasoned *Silicon Graphics* cases are evidence that a uniform pleading standard does not exist, and consequently, the federal district courts are deciphering the language of the statute for themselves.

Silicon Graphics I was decided on September 25, 1996.[68] The district court held that the plaintiffs "must allege specific facts that constitute circumstantial evidence of conscious behavior by defendants."[69] After a brief analysis of the Reform Act's legislative history, the court further found that Congress did not intend to codify the Second Circuit's standard for pleading scienter in its entirety, as evidenced in the Conference Committee Report accompanying the Reform Act.[70] The court asserted that "[b]ecause Congress chose not to include that language from the Second Circuit standard relating to motive, opportunity, and recklessness, Congress must have adopted the Conference Committee view and intended that a narrower first prong apply."[71] Thus, the court dismissed *Silicon Graphics I* with leave to amend.[72]

Silicon Graphics II, decided on May 23, 1997, reiterates and expands on the holding in *Silicon Graphics I*.[73] The *Silicon Graphics II* court specified that "deliberate recklessness" is the scienter requirement which constitutes "a strong inference of knowing or intentional misconduct."[74] The deliberate recklessness standard favored by Judge Smith was described in *Hollinger v. Titan Capital*

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66. *See* Coffee, Jr., *supra* note 59, at 5. This ruling has been described as "terrible" because it will be too difficult for victims of securities fraud to satisfy a deliberate recklessness standard. *See* Bruce Rubenstein, *Fraud Failsafe or License to Lie: Big Decisions on Securities Reform Act Coming; State and Federal Courts to Rule*, CORP. LEGAL TIMES, Nov. 1997, at 1 (analyzing recent court decisions).

67. *See* Brodsky, *supra* note 64, at 3.

68. *See Silicon Graphics I*, No. 96-0393, 1996 WL 664639, at *1 (N.D. Cal. Sept. 25, 1996).

69. *See id.* at *6.

70. *See id.* at *5-*6. As further evidence of the intent to heighten the pleading standard, the court referenced a Senate bill under consideration. *See id.* at *5. The Senate bill codified the standard of the Second Circuit; however, the Conference Committee rejected this version of the bill. *See id.* The court also found support for its analysis in President Clinton's veto of the bill and his accompanying explanation that Congress had "made crystal clear . . . their intent to raise the standard." *See id. See also supra* note 2 and accompanying text.

71. *Silicon Graphics I*, 1996 WL 664639, at *6. Therefore, facts constituting circumstantial evidence of conscious behavior by defendants must be pleaded. *See id.*

72. *See id.* at *16; *see also* Powers v. Eichen, 977 F. Supp. 1031, 1039 (S.D. Cal. 1997) (agreeing with Judge Smith's reasoning in *Silicon Graphics I* invoking a stricter pleading standard for scienter).

73. *Silicon Graphics II*, 970 F. Supp. 746, 746 (N.D. Cal. 1997).

74. *See id.* at 757. Some commentators speculate that Judge Smith's clarification is an attempt to protect the court's decision on appeal, while others believe this clarification is a natural progression from the judge's well-reasoned opinion. *See* Brodsky, *supra* note 64, at 3.

Corp.,[75] but "[u]nfortunately is neither universally accepted, nor universally applied."[76] Deliberate recklessness is defined as "a highly unreasonable omission, involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is *either known to the defendant or so obvious that the actor must have been aware of it.*"[77]

The *Silicon Graphics II* court noted that even within the Second Circuit, case law is conflicting as to what constitutes scienter for purposes of section 10(b).[78] The court analyzed three lines of Second Circuit authority that have addressed the scienter requirement.[79] The three distinct approaches illustrated to the court that a uniform standard did not exist within the Second Circuit, thereby bolstering the court's theory as to why Congress did not codify the Second Circuit's law.[80] Specifically, the court found that the Second Circuit's lack of uniformity was contradictory to the Reform Act's legislative intent to establish "uniform and more stringent pleading requirements to curtail the filing of meritless lawsuits."[81] The court recognized that the legislative history of the Reform Act had not been entirely consistent because the legislators themselves were unable to agree upon the contours of the Second Circuit's standard.[82] However, the court found that the

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75. 914 F.2d 1564, 1568 (9th Cir. 1990) (holding that recklessness, as defined by the court, may satisfy the scienter requirement for damages under a section 10(b) claim and rule 10b-5). The deliberate recklessness standard was also alluded to in *Hochfelder*. *See Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 197 (1976); *Silicon Graphics II*, 970 F. Supp. at 757.

76. *See Silicon Graphics II*, 970 F. Supp. at 755. This definition of recklessness appears compatible with Supreme Court cases. *See id.*

77. *See id.* (emphasis added) (quoting *Hollinger*, 914 F.2d at 1569); *see also* Brodsky, *supra* note 64, at 3.

78. *See Silicon Graphics II*, 970 F. Supp. at 755.

79. *See id.* The *Silicon Graphics II* court cited numerous cases in their analysis. *See id.* First, the court cited *Lanza v. Drexel & Co.*, 479 F.2d 1277 (2d Cir. 1973) (*en banc*), which permitted "unqualified allegations of recklessness" to establish scienter. *See Silicon Graphics II*, 970 F. Supp. at 755 (citing *Lanza*, 479 F.2d at 1306). Second, the court cited *Rolf v. Blyth, Eastman Dillon & Co.*, 570 F.2d 38 (2d Cir. 1978), *amended by* 1978 WL 4098 (2d Cir. May 22, 1978), which permitted "recklessness to establish scienter only if the defendant also had a fiduciary duty to the plaintiff." *Silicon Graphics II*, 970 F. Supp. at 755 (citing *Rolf*, 570 F.2d at 44). Last, the court cited *Weschler v. Steinberg* 733 F.2d 1054 (2d Cir. 1984), which was the strictest approach, requiring "actual intent or circumstances implying actual intent before finding scienter." *See Silicon Graphics II*, 970 F. Supp. at 755 (citing *Weschler*, 733 F.2d at 1058).

80. *See Silicon Graphics II*, 970 F. Supp. at 755-57.

81. *See id.* at 755-56 (quoting H.R. CONF. REP. NO. 104-369, at 41 (1995), *reprinted in* 1995 U.S.C.C.A.N. 736). Furthermore, because language referring to motive, opportunity and recklessness was left out of the Reform Act, the court asserted that Congress appears to favor the *Weschler* approach as opposed to the *Lanza* and *Rolf* lines of authority. *See id.*

82. *See id.* at 756-57. Again, the court placed emphasis on President Clinton's veto. *See id.* at 756; *see also supra* notes 70-71 and accompanying text.

Conference Committee Report and the final text of the Reform Act adopted contained the most persuasive evidence of legislative intent.[83] Consequently, the court disagreed with claims stating that mere recklessness is still an applicable standard under the Reform Act because the recklessness language, along with motive and opportunity, had been precisely omitted from the Reform Act.[84] In sum, under *Silicon Graphics II*, "[m]otive, opportunity, and non-deliberate recklessness may provide some evidence of intentional wrongdoing, but are not alone sufficient to support scienter unless the totality of the evidence creates a strong inference of fraud."[85]

Taking the heightened pleading standard into consideration, the court in *Silicon Graphics II* held that the plaintiffs' amended complaint was too generic.[86] In order to provide sufficiently detailed information about the alleged negative internal reports, the plaintiffs' allegations "should include the titles of the reports, when they were prepared, who prepared them, to whom they were directed, their content, and the sources from which plaintiffs obtained this information."[87] The court stated that the extent of disclosure required from the plaintiffs conformed to the Reform Act's pleading requirements.[88] The court supported its decision by finding that the plaintiffs' amended allegations did not even meet the requirements set forth under the Second Circuit's standard of providing names and dates, much less the new, stricter pleading standard favored by the Reform Act.[89] While the plaintiffs also made an in camera submission to the court, the court declined to review this material.[90] The court, however, noted the possibility that this submission may have contained sources or specific facts as required by the Reform Act that would improve the plaintiffs' allegations of fraud.[91] Subsequently, the court allowed plaintiffs an opportunity to supplement their pleadings.[92]

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83. *See Silicon Graphics II*, 970 F. Supp. at 757.
84. *See id.*
85. *Id.*
86. *See id.* at 767.
87. *Id.* The extent of disclosure was the subject of Congressional debate. *See id.* at 763. Representative Bryant was concerned by the extent of specificity a heightened pleading standard imposes on plaintiffs from the outset of their claim. *See id.* Moreover, Representative Dingell voiced concerns that the heightened pleading standard requires the disclosure of the names of confidential informants, employees, competitors, and others who provide information leading to the filing of the case. *See id.* Nevertheless, the court found that the Reform Act imposes the strict standards with which both representatives were concerned. *See id.* The strict pleading standard forces plaintiffs to allege all improprieties they are charging up front, but it does not require plaintiffs to immediately prove these allegations. *See* Rubenstein, *supra* note 66, at 1. The strict pleading standard effectively avoids a "fishing expedition," a lawsuit which occurs when "somebody does not know what they are after at first." *See id.* at 1 (quoting Rep. Christopher Cox, R-Cal.).
88. *See Silicon Graphics II*, 970 F. Supp. at 767.
89. *See id.*
90. *See id.*
91. *See id.*
92. *See id.* at 768.

The plaintiffs declined Judge Smith's invitation to amend the pleadings and instead referred the court to the in camera submission previously made.[93] Although the plaintiffs' in camera submission may have contained specific sources or facts that the court requested, the court declined to review the resubmission.[94] The court firmly held its prior position, stating that the information requested from the plaintiffs, which required specific allegations of securities fraud, was not privileged material as the plaintiffs had contended.[95] The court dismissed the resubmission with prejudice,[96] and the case is currently on appeal to the Ninth Circuit Court of Appeals.[97]

Before the *Silicon Graphics II* trial court rendered its decision, the SEC filed an amicus curiae brief in February 1997.[98] In the brief, the Commission urged the district court to reconsider its earlier decision in *Silicon Graphics I*, which found that mere recklessness was insufficient for liability under section 10(b) of the Exchange Act and under rule 10b-5.[99] The Commission asserted that the Reform Act does not change the definition of the state of mind required in a private securities fraud action.[100] Instead, the SEC asserted that Congress "only sought to strengthen pleading standards, not to change the substantive standard for scienter."[101] The Commission alleged that "[i]n determining that section 21D(b)(2) required the pleading of conscious behavior, the Court drew from a purely procedural provision the incorrect conclusion that Congress had eliminated a well

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93. *See* Silicon Graphics, Inc. Sec. Litig., No. C 96-0393 FMS, 1997 WL 337580, at *1 (N.D. Cal. June 5, 1997).

94. *See id.*

95. *See id.* The court stated that "[p]laintiffs have cited no authority, and the Court is aware of none, that allows a party to base its pleadings on secret information to which the opposition is denied access and an opportunity to respond." *Id.*

96. *See id.*

97. *See Ninth Circuit to Decide How Much Detail is Required by Reform Act: In re Silicon Graphics Securities Litigation*, ANDREWS SEC. & COMMODITIES LITIG. REP., July 9, 1997, at 12. The SEC filed an amicus curiae brief with the Ninth Circuit Court of Appeals asking the court to reconsider the district court's decision. *See* Brief of the Securities and Exchange Commission, Amicus Curiae, *Silicon Graphics II* (No. 97-16240) (last modified Dec. 1, 1997) <http://securities.stanford.edu/briefs/sgi/9716240/sec.html>.

98. *See Commission Files Amicus Brief in Silicon Graphics Litigation*, S.E.C. NEWS RELEASE, Feb. 4, 1997, *available in* 1997 WL 41379 [hereinafter *Commission Files Amicus Brief*].

99. *See* Brief of the Securities and Exchange Commission, Amicus Curiae, Concerning Defendants' Motion to Dismiss the Amended Complaint at 9, *Silicon Graphics II* (No. C 96-0393 FMS) [hereinafter *Amicus Curiae, February 1997*]. *But see* Brief of the American Electronics Association, Amicus Curiae, Regarding Defendants' Motion to Dismiss the Amended Complaint, *Silicon Graphics II* (No. C 96-0393 FMS) (supporting Judge Smith's interpretation of the Reform Act by stating that this was exactly what Congress had in mind).

100. *See Amicus Curiae, February 1997*, *supra* note 99, at 9.

101. *See id.* at 8.

established substantive standard."[102] The Commission contended that it has consistently supported a recklessness standard for pleading fraud, that a recklessness standard prevents defendants from escaping liability in comparison to knowledge or conscious intent standards which are more difficult to prove, and that any retreat from the recklessness standard will erode the deterrent effect of section 10(b) actions.[103] Furthermore, a recklessness standard is "needed to protect investors and the securities markets from fraudulent conduct and to protect the integrity of the disclosure process."[104] The Commission urged that a "higher scienter standard would lessen the incentives for corporations to conduct a full inquiry into potentially troublesome or embarrassing areas, and thus would threaten the process that has made our markets a model for nations around the world."[105]

If the Commission is correct, then one must ask why Congress did not codify the Second Circuit's standard for pleading fraud. Richard H. Walker, the General Counsel for the SEC, attempted to address this question when he stated, "[w]hile Congress certainly sought to strengthen the pleading requirements in private securities fraud actions, it clearly did not intend to eliminate liability for reckless behavior. The recklessness standard requires a high level of culpability and has long been recognized by the courts as sufficient for a finding of fraud."[106] However, Mr. Walker's statement is contrary to general sentiments expressed in the Conference Committee Report accompanying the Reform Act.[107] The Conference Committee specifically noted testimony from both House and Senate hearings expressing "the need to establish uniform and more stringent pleading requirements to curtail the filing of meritless lawsuits."[108] The Conference Committee further noted that even though the plaintiffs are required to plead fraud under rule 9(b) of the Federal Rules of Civil Procedure with particularity, this standard has not deterred meritless lawsuits as securities laws are still abused by private litigants.[109]

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102. *Id.* at 3. The Commission believed that the district court erroneously relied on footnote 23 of the Conference Committee Report and the report's omission of language referring to "motive, opportunity, or recklessness" to support its position that only a conscious behavior standard met the strong inference test. *See id.* at 11-13. The Commission asserted that footnote 23 "merely explains the result of the Conference Committee's decision not to codify the Second Circuit's case law interpreting the pleading standard." *See id.* at 12. Instead, the Commission opined that Congress preferred to allow the courts to use their discretion "to create their own standards for determining whether a plaintiff has established the required strong inference." *See id.* at 13. Thus, the Commission further stated that recklessness is a sufficient standard so long as the "plaintiffs can state with particularity facts giving rise to a strong inference that defendants acted" with the required state of mind. *See id.*

103. *See id.* at 3.

104. *See id.*

105. *Id.*

106. *Commission Files Amicus Brief, supra* note 98, at *1.

107. *See* H.R. CONF. REP. NO. 104-369, at 36 (1995), *reprinted in* 1995 U.S.C.C.A.N. 736.

108. *See id.* at 41.

109. *See id.* at 26-27. Abuses include: (1) the routine filing of lawsuits whenever there is a significant decline in the issuer's stock price without regard to culpability and "with only faint hope" that discovery will lead to "some plausible cause of action;" (2) targeting "deep pocket defendants"

B. The First Circuit

In *Friedberg v. Discreet Logic, Inc.*,[110] a First Circuit district court discussed the proper pleading standard under the Reform Act.[111] In order to satisfy the Reform Act's "strong inference of scienter" requirement, the court held that "the plaintiff must set forth specific facts that constitute strong circumstantial evidence of conscious behavior by defendants."[112] According to the *Friedberg* court, "reasonable belief" was the appropriate pre-Reform Act pleading standard in the First Circuit.[113] The court asserted that the Reform Act then raised the pleading standard to a strong inference of scienter, but failed to give the court guidance as to what constitutes a strong inference.[114] Consequently, the court was forced to rely upon the Reform Act's legislative history.[115]

The *Friedberg* court noted that at the time of the Reform Act's passage, the Second Circuit's pleading standard already existed.[116] However, the court concluded that the Reform Act essentially discarded that standard because of the Conference Committee's intent to strengthen the existing pleading requirements.[117] The court reasoned that because of this goal, the Conference Committee "purposely chose not to include in its pleading standard language derived from Second Circuit case law relating to motive, opportunity or recklessness."[118] Instead, the court supported the Second Circuit's conscious behavior standard because the circumstantial allegations a plaintiff must plead to constitute conscious behavior are greater and stronger than those needed to show motive and opportunity.[119] The court had a difficult time differentiating between reckless behavior and conscious behavior as they are commonly placed in the same category, but the court reasoned

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without regard to culpability; (3) imposing burdensome and costly discovery processes which force defendants to settle; and (4) "manipulation" by class action lawyers of plaintiffs they purport to represent. *See id.* These abuses are rarely mitigated because judges are reluctant to impose any sanctions under rule 11 of the Federal Rules of Civil Procedure. *See id.* at *27. These abuses also adversely affect investors and the economy because the highly qualified individuals are reluctant to become involved in securities-related positions as they fear frivolous and costly lawsuits. *See id.*

110. 959 F. Supp. 42 (Mass. Dist. Ct. 1997).

111. *See id.* at 48.

112. *See id.* at 49-50.

113. *See id.* at 48 (citing Shaw v. Digital Equip. Corp., 92 F.3d 1194, 1223-24 (1st Cir. 1996)).

114. *See id.* (citing H.R. CONF. REP. NO. 104-369, at 41 (1995)).

115. *See id.*

116. *See id.*

117. *See id.* As evidence of the intent to heighten the pleading standard, the court referenced footnote 23 of the Conference Committee Report. *See id.* (citing H.R. CONF. REP. NO. 104-369, at 41).

118. *See id.*

119. *See id.* at 49.

that conscious behavior is the more stringent standard because "circumstantial evidence indicating intent to defraud or knowledge of the falsity" must be pleaded.[120] The court's rationale was supported by the Reform Act's elimination of language referring to recklessness from the pleading standard.[121]

C. The Second Circuit

The Second Circuit provides the second most active forum for securities lawsuits.[122] *Norwood Venture Corp. v. Converse Inc.*[123] was among the first cases in the Second Circuit to engage in the long discussion regarding the pleading standard under the Reform Act.[124] The *Norwood* court asserted that the Reform Act imposes a higher pleading standard than that of the Second Circuit by holding that a plaintiff must plead conscious misrepresentations or omissions.[125] Judge Baer noted that the Conference Committee Report accompanying the Reform Act reflected Congress's choice not to include certain language from the second prong of the Second Circuit's standard relating to motive, opportunity, or recklessness in the pleading standard.[126] However, the court found it "instructive to look at the first prong of the Second Circuit's standard" to decipher what satisfies the post-Reform Act pleading standard.[127] Because the Conference Committee Report failed to expressly reject the applicability of the Second Circuit's conscious behavior pleading standard, the court decided to apply that standard under the Reform Act.[128] While *Norwood* did not specifically address whether recklessness survives as a valid pleading standard, the court essentially dismissed its applicability through an explanation of what constitutes conscious behavior.[129] From that discussion, it is apparent that mere recklessness does not satisfy the knowing misrepresentation standard supported by the court.[130]

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120. *See id.*

121. *See id.*

122. *See* Grundfest & Perino, *supra* note 49, and text accompanying table 12. Between December 22, 1995 and December 31, 1996, 18.1% of all securities class actions were filed in the New York district courts. *See id.*

123. 959 F. Supp. 205 (S.D.N.Y. 1997).

124. *See id.* at 208.

125. *See id.*

126. *See id.* Judge Baer cited to footnote 23 of the Conference Committee Report to explain the intent behind the omission of this language. *See id.* (citing H.R. CONF. REP. NO. 104-369, at 41 (1995)).

127. *See id.*

128. *See id.* The court stated that factual statements coupled with "conclusory allegations of fraudulent intent" do not satisfy the pleading standard for scienter. *See id.*

129. *See id.* at 208-09.

130. *See id.* The court noted that allegations of "a prosperous future compared to a bleaker reality" do not rise to the level of "knowing misrepresentation." *See id.*

However, in *In re Baesa Securities Litigation*,[131] the court utilized a plain language approach to the Reform Act to determine whether a heightened pleading standard exists.[132] The *Baesa* court differed from the *Norwood* court by holding that the Reform Act did not heighten the substantive law scienter requirement in private securities fraud actions by requiring more than recklessness.[133] However, the court found that the Reform Act no longer permits under procedural law the mere pleading of motive and opportunity alone to automatically establish a strong inference of scienter.[134] Because the Reform Act fails to address what is specifically needed to satisfy the substantive requirement of scienter, the *Baesa* court looked to the Exchange Act itself and to existing case law for guidance.[135] The court recognized and accepted precedent holding that recklessness suffices as an adequate state of mind to find securities fraud.[136] The court reasoned that because the Reform Act does not explicitly refute recklessness as a substantive law standard, it remains a viable form of scienter in private securities fraud litigation.[137] While the substantive law for the required state of mind in securities fraud remains constant, the *Baesa* court found that the Reform Act does heighten the pleading standard.[138] The court reasoned that because the Reform Act does not mention motive and opportunity, the plain language of the statute dictates that motive and opportunity alone do not automatically suffice to raise a strong inference of scienter.[139]

The *Baesa* holding received favorable reaction, causing one commentator to state the following:

> [T]he *Baesa* ruling is much more favorable to securities-suit plaintiffs than the *Silicon Graphics* ruling was. But, because it toughens the motive-and-opportunity

131. 969 F. Supp. 238 (S.D.N.Y. 1997).
132. *See id.* at 241.
133. *See id.* at 239.
134. *See id.* at 242.
135. *See id.* at 240.
136. *See id.* at 241. Typically, recklessness in securities fraud cases embraces "some form of conscious disregard." *See id.* This is because "'[r]eckless conduct is, at the least, conduct which is highly unreasonable and which represents an extreme departure from the standards of ordinary care . . . to the extent that the danger was either known to the defendant or so obvious that the defendant must have been aware of it.'" *Id.* (alteration in original) (quoting Chill v. General Elec. Co., 101 F.3d 263, 269 (2d Cir. 1996)).
137. *See id.* at 241. The *Baesa* court stated that cases suggesting otherwise had "substituted a selective reading of the convoluted legislative history for the clear and unambiguous language of the statute. When the statutory text is so plain, resort to legislative history is neither necessary nor prudent." *See id.*
138. *See id.* at 242.
139. *See id.*

standard, it doesn't simply endorse the previous status quo . . . .

. . . "It's a somewhat new stance on what must be shown" to establish that a defendant had the requisite mental state to be liable for securities fraud.[140]

The SEC was particularly delighted with the *Baesa* holding and was in full agreement that recklessness remains a viable post-Reform Act substantive law standard.[141]

Another recent district court case in the Second Circuit is *In re Glenayre Technologies, Inc. Securities Litigation.*[142] In *Glenayre*, Judge Baer clarified and reaffirmed the court's decision in *Norwood*, by applying the *Norwood* holding to *Glenayre*.[143] Judge Baer specified that "'motive and opportunity' alone will no longer suffice to meet the required pleading standard" under the Reform Act.[144] The court quickly clarified that the Reform Act did not change the substantive law but only changed the pleading standard that must be met to raise a strong inference of scienter.[145] Thus, recklessness meets the scienter requirement as long as it is conscious recklessness.[146] Furthermore, Judge Baer asserted that this more stringent pleading standard has become the new law for the Southern District of New York.[147]

Not all district courts in New York, however, have departed from the traditional Second Circuit standard for pleading securities fraud. For example, the court in *Sloane Overseas Fund, Ltd. v. Sapiens International Corp.*[148] summarized the Reform Act as codifying the Second Circuit's standard for pleading fraud.[149] More recently, the court in *Shahzad v. H.J. Meyers & Co.*[150] also adopted the Second Circuit's standard for pleading fraud.[151] Similarly, the court in *In re*

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140. Michael Rapoport, *Baesa Ruling Strikes Middle Ground on Secur-Suit Standard*, DOW JONES NEWS SERV., July 9, 1997, *available in* WESTLAW DJNSPLUS database (quoting John Coffee, law professor and securities expert at Columbia University).

141. *See id.*

142. 982 F. Supp. 294 (S.D.N.Y. 1997).

143. *See id.* at 298.

144. *See id.* However, this approach does not completely disregard facts showing motive and opportunity. *See id.* Such facts can be taken into account when determining if "a complaint raises a strong inference of knowing misrepresentation." *See id.*

145. *See id.* Judge Baer asserted that *Baesa*'s plain language interpretation of the Reform Act renders this same view. *See id.*

146. *See id.* Judge Baer stated, "I emphasize, however, that recklessness in this context approximates actual intent, and is not merely a heightened form of negligence." *Id.*

147. *See id.; see also In re* Baesa Sec. Litig., 969 F. Supp. 238, 239 (S.D.N.Y. 1997); Norwood Venture Corp. v. Converse Inc., 959 F. Supp. 205, 208-09 (S.D.N.Y. 1997).

148. 941 F. Supp. 1369 (S.D.N.Y. 1996).

149. *See id.* at 1377.

150. No. 95 Civ. 6196 (DAB), 1997 WL 47817, at *1 (S.D.N.Y. Feb. 6, 1997).

151. *See id.* at *7 n.6. The court further stated that it was applying the standard for pleading fraud as articulated in *San Leandro Emergency Medical Group Profit Sharing Plan v. Philip Morris Co.*, 75 F.3d 801 (2nd Cir. 1996). *See Shahzad*, 1997 WL 47817, at *7 n.6. However, *San Leandro* was argued September 12, 1995, before the Reform Act was applicable. *See San Leandro*, 75 F.3d at 801.

Wellcare Management Group, Inc. Securities Litigation[152] applied both the motive and opportunity and conscious or reckless behavior tests to determine whether the complaint sufficiently pleaded scienter.[153] Moreover, the court in *Pilarczyk v. Morrison Knudsen Corp.*[154] followed the Second Circuit standard for pleading securities fraud and asserted that the Reform Act merely adopts the stringent standards of the Second Circuit.[155]

Another case, *OnBank & Trust Co. v. Federal Deposit Insurance Corp.*,[156] followed the Second Circuit standard for pleading securities fraud.[157] Chief Judge Larimer refuted arguments that the pleading standard had been heightened as a result of the assertions set forth in the Conference Committee Report, especially with respect to footnote twenty-three.[158] Chief Judge Larimer stated that he was not convinced that a "single, ambiguous statement" could invalidate established, pre-Reform Act, Second Circuit case law which holds that motive, opportunity, and recklessness adequately plead the scienter requirement in securities fraud litigation.[159] Furthermore, Chief Judge Larimer opined that Congress's failure to explicitly codify Second Circuit case law by specifying this language in the Reform Act was not evidence of Congress's intent to overturn established law.[160] Chief Judge Larimer further concluded that "[a]s long as the court applies the statute as written, allegations of motive, opportunity, or reckless behavior may still be relevant."[161]

The *In re Health Management, Inc. Securities Litigation*[162] opinion recognized that the two Second Circuit cases which have conducted extensive analytical evaluation of the Reform Act, *Norwood* and *Baesa*, hold inapposite views which are either derived by a thorough examination of the Reform Act's legislative history or by undertaking a strict, plain reading of the statute.[163] However, the *Health Management* court was not completely swayed by either opinion and held that both recklessness as well as motive and opportunity are sufficient to plead a

152. 964 F. Supp. 632 (N.D.N.Y. 1997).
153. *See id.* at 638-40.
154. 965 F. Supp. 311 (N.D.N.Y. 1997).
155. *See id.* at 320.
156. 967 F. Supp. 81 (W.D.N.Y. 1997).
157. *See id.* at 88.
158. *See id.* at 88 n.4.
159. *See id.*
160. *See id.*
161. *Id.*
162. 970 F. Supp. 192 (E.D.N.Y. 1997).
163. *See id.* at 201.

strong inference of scienter under the Reform Act.[164] The court reasoned that the motive and opportunity test is not abrogated under the Reform Act because if the standard under the Reform Act was to be one of knowing misbehavior, Congress would not have omitted communicating this intent in the statute.[165] Instead, the court reasoned that because Congress decided to omit such specific language, the Second Circuit standard remains viable.[166] The court further asserted that Congress intended the courts to determine on a case-by-case basis whether plaintiffs have satisfied the pleading standard.[167] Thus, by upholding the Second Circuit's standard, the court could take into consideration motive and opportunity, conscious misbehavior, recklessness, or other novel legal theories impressed upon the court.[168]

D. The Third Circuit

Traditionally, in order to plead scienter, the Third Circuit has required plaintiffs "to allege facts demonstrating that a defendant 'lacked a genuine belief that the information disclosed was accurate and complete in all material respects.'"[169] Thus, plaintiffs could plead circumstantial evidence or recklessness to meet the requirement for scienter.[170] Post-Reform Act, federal district courts in the Third Circuit are slowly beginning to take into consideration the possibility of a heightened pleading standard.

Voit v. Wonderware Corp. is a Third Circuit case which was particularly influenced by both the *Norwood* and *Friedberg* courts' interpretations of the Reform Act.[171] Likewise, the *Voit* court analyzed the Reform Act's legislative history and held that Congress intended a more stringent pleading standard than that articulated by the Second Circuit.[172] The *Voit* court specifically adopted the *Friedberg* court's conscious behavior pleading standard and also found this approach to be consistent with the *Norwood* court's knowing misrepresentation standard.[173] Applying the Second Circuit's standard, the *Voit* court found that "the 'conscious behavior' standard is more difficult to pass than the 'motive and opportunity' or 'recklessness' standards."[174] Consequently, to meet the conscious

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164. *See id.* The *Health Management* court found the *Baesa* holding persuasive to the extent it upholds recklessness as a form of scienter, but disagreed with the *Baesa* court's assertion that the pleading of motive and opportunity does not adequately allege scienter. *See id.*

165. *See id.*

166. *See id.*

167. *See id.*

168. *See id.*

169. Voit v. Wonderware Corp., 977 F. Supp. 363, 373 (E.D. Pa. 1997) (quoting *In re* Phillips Petroleum Sec. Litig., 881 F.2d 1236, 1244 (3d Cir. 1989)).

170. *See id.*

171. *See id.* at 374.

172. *See id.*

173. *See id.*

174. *See id.*

behavior approach, plaintiffs must "allege facts which give rise to a strong inference or constitute strong circumstantial evidence of either knowing or conscious behavior."[175]

Berkowitz v. Conrail, Inc.[176] was decided approximately three weeks after *Voit*.[177] The *Berkowitz* court noted recent federal district court activity either refuting or supporting a heightened pleading standard, but failed to reach a conclusion.[178] However, the court believed that at a minimum the Reform Act codified the Second Circuit's pleading standard.[179]

E. The Fifth Circuit

Pre-Reform Act, the Fifth Circuit held that fraudulent intent could be found where motive to commit fraud was presented.[180] Post-Reform Act, decisions made by federal district courts in the Fifth Circuit have not strayed from the Second Circuit's approach to pleading securities fraud.[181] The decision in *STI Classic Fund v. Bollinger Industries, Inc.*, which implicitly upheld the Second Circuit's standard, was first recommended by a magistrate,[182] and then affirmed by the chief district judge.[183] The *STI Classic Fund I* court was particularly influenced by the *Marksman* court and also concluded that the motive and opportunity test was still applicable.[184] Like the *Marksman* court, the *STI Classic Fund I* court believed that had Congress disapproved of the motive and opportunity test, then Congress would have explicitly stated its disapproval in the Reform Act.[185]

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175. *See id.*
176. No. CIV.A.97-1214, 1997 WL 611606, at *1 (E.D. Pa. Sept. 25, 1997).
177. *See id.* at *1.
178. *See id.* at *15.
179. *See id.*
180. *See* STI Classic Fund v. Bollinger Indus., Inc., No. CA 3:96-CV-0823-R, 1996 WL 885802, at *1 (N.D. Tex. Oct. 25, 1996) [hereinafter *STI Classic Fund I*].
181. *See id.*
182. *See id.*
183. *See* STI Classic Fund v. Bollinger Indus., Inc., No. CA 3: 96-CV-0823-R, 1996 WL 866699, at *1 (N.D. Tex. Nov. 12, 1996).
184. *See STI Classic Fund I*, 1996 WL 885802, at *1.
185. *See id. Williams v. WMX Technologies, Inc.*, 112 F.3d 175 (5th Cir. 1997), also upheld the Second Circuit's standard, but *Williams* was filed prior to the effective date of the Reform Act. *See id.* at 178.

F. The Sixth Circuit

The court in *Havenick v. Network Express, Inc.*[186] interpreted the Reform Act as expanding rule 9(b) of the Federal Rules of Civil Procedure.[187] The court analyzed the language of the Reform Act and its legislative history and stated that the appropriate pleading standard for securities fraud was met by combining the Reform Act and the traditionally accepted application of the Sixth Circuit's Federal Rules of Civil Procedure 9(b) jurisprudence.[188] Through this interpretation, the *Havenick* court endorsed a heightened pleading standard which eliminated the Second Circuit's recklessness and motive and opportunity tests for pleading scienter.[189]

G. The Seventh Circuit

Rehm v. Eagle Finance Corp.[190] was the first case in the Seventh Circuit to discuss the pleading standard for fraud.[191] The court held that "[d]espite conflicting judicial views on this issue, and ambivalent language in the legislative history, we agree with plaintiff that [the Reform Act] does not impose a more rigorous pleading requirement than that enunciated by the Second Circuit."[192] The court specifically found that the Reform Act "adopts the Second Circuit standard," but that the

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186. 981 F. Supp. 480 (E.D. Mich. 1997).

187. *See id.* at 524. The court recognized the language in footnote 23 of the Conference Committee Report as proof of the Committee's intent to heighten the pleading standard. *See id.*

188. *See id.* The court stated that the plaintiffs' complaint should specify:

> (1) the parties and the participants to the alleged fraud; (2) the time, place and content of the representations; (3) each statement alleged to have been misleading; (4) the reason or reasons why the statement is misleading; (5) if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed; (6) the fraudulent scheme; (7) the fraudulent intent of the defendants; (8) reliance on the fraud; and (9) the injury resulting from the fraud.

Id. Note that language referring to motive, opportunity, or recklessness is not mentioned. *See id.* *Havenick* was not the first case in the Sixth Circuit to decide that the pleading standard was heightened under the Reform Act. *See Securities Litigation Abuses: Concerning S. 1260, the "Securities Litigation Uniform Standards Act of 1997," Before the Subcomm. on Sec. of the Senate Comm. on Banking, Hous., and Urban Affairs,* 105th Cong. (1997) (statement of Arthur Levitt, Jr., Chairman, SEC) (discussing *In re* Comshare, Inc. Sec. Litig., 1997 U.S. Dist. LEXIS 17262 (E.D. Mich. Sept. 18, 1997)), *available in* 1997 WL 14152726. Currently, *Hoffman v. Comshare, Inc.*, is on appeal to the Sixth Circuit Court of Appeals. *See* Brief of the Securities and Exchange Commission, Amicus Curiae, *Comshare*, (No. 97-2098) (last modified Jan. 9, 1998) <http://securities.stanford.edu/briefs/comshare/9702098/sec.html> The district court in *Hoffman* found that the Reform Act required plaintiffs to plead specific facts creating a strong inference of knowing misrepresentations on behalf of the defendants. *See id.*

189. *See Havenick*, 981 F. Supp. at 524.

190. 954 F. Supp. 1246 (N.D. Ill. 1997).

191. *See id.* at 1252.

192. *Id.* (citations omitted).

Reform Act "declines to bind courts" to this standard.[193] The court stated that the three factors pertaining to the Reform Act's language, history, and purpose justify its conclusion.[194] First, the strong inference language used in the Reform Act "mirrors the language traditionally employed by the Second Circuit in its application of rule 9(b) to scienter pleadings."[195] The court inferred that the verbatim use of the language strongly indicates an intent to enact the same pleading standard for the Reform Act.[196] Second, the court found that "the legislative history supports a reading of the [Reform Act] consistent with this view."[197] Third, the court believed that adopting the Second Circuit's standard, it best reconciled "conflicting policy concerns underlying the [Reform Act].[198] The court further expressed that by "[r]atchetting up the standard to conform with the stringent Second Circuit test satisfies Congress' goal of curtailing abusive securities litigation while still leaving room for aggrieved parties to bring valid securities fraud claims."[199] Furthermore, "[t]o impose a higher pleading standard would make it extremely difficult to sufficiently plead a 10b-5 claim—an outcome which would certainly be contrary to the broad remedial purposes of the federal securities laws."[200]

Approximately two months later, *Fugman v. Aprogenex, Inc.*[201] was decided. The holding in *Fugman* followed *Rehm.*[202] Without entering into a long analytical discussion, the court found guidance in and accepted the *Rehm* court's decision adopting the Second Circuit's standard.[203] The *Fugman* court was particularly persuaded by Judge Moran's well-reasoned opinion based upon the legislative history of the Reform Act.[204] Similarly, *Gilford Partners, L.P. v. Sensormatic Electronics Corp.,*[205] the most recent case decided in the Seventh Circuit, followed *Rehm.*[206] The *Gilford* court stated that scienter could be pleaded by motive and opportunity or facts that constitute strong circumstantial evidence of conscious

193. *See id.*
194. *See id.*
195. *See id.*
196. *See id.*
197. *Id.*
198. *See id.*
199. *Id.* (citations omitted).
200. *Id.*
201. 961 F. Supp. 1190 (N.D. Ill. 1997).
202. *See id.* at 1195; *see also* Galaxy Inv. Fund, Ltd. v. Fenchurch Capital Management, Ltd., No. 96 C 8098, 1007 U.S. Dist. LEXIS 13207, at *36-*37 (N.D. Ill. Aug. 29, 1997) (holding that the Second Circuit's standard has been codified under the Reform Act).
203. *See Fugman*, 961 F. Supp. at 1195.
204. *See id.*
205. No. 96 C 4072, 1997 WL 757495, at *1 (N.D. Ill. Nov. 24, 1997).
206. *See id.* at *18.

misbehavior or recklessness.[207]

H. The Eleventh Circuit

Two Eleventh Circuit cases have touched upon the pleading standard for securities fraud after the Reform Act, but neither case engaged in any meaningful analytical discussion. *Fischler v. Amsouth Bancorporation*[208] adopted the Second Circuit's standard for pleading securities fraud.[209] *Page v. Derrickson,*[210] which follows *Fischler*, also adopted both prongs of the Second Circuit standard as means of establishing a strong inference.[211]

Two other Eleventh Circuit cases, *Gross v. Medaphis Corp.*[212] and *In re ValuJet, Inc.,*[213] have failed to establish the appropriate pleading standard for securities fraud under the Reform Act.[214] The *Gross* court did not find a need to resolve this issue because the plaintiffs in the case were able to meet both prongs articulated in the Second Circuit's standard.[215] In a footnote, the *Gross* court noted that a majority of the courts have agreed with *Rehm* and that the "[c]ourts have given deference to the views of the SEC in matters relating to the interpretation and enforcement of the federal securities laws."[216] The *ValuJet* court also held that it was not necessary to conclude whether the plaintiffs met the appropriate post-Reform Act pleading standard for securities fraud because the facts pleaded by the plaintiffs met both tests articulated under the Second Circuit's standard.[217]

IV. CONCLUSION

The longterm legal implications of the decisions reached thus far by courts considering the pleading standard under the Reform Act are difficult to predict, because recent decisions have only been made at the district court level and will not reach the appellate court level for some time.[218] Nevertheless, if courts tend to

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207. *See id.*
208. 971 F. Supp. 533 (M.D. Fla. 1997).
209. *See id.* at 535.
210. No. 96-842-CIV-T-17C, 1997 WL 148558 (M.D. Fla. Mar. 25, 1997).
211. *See id.* at *9.
212. 977 F. Supp. 1463 (N.D. Ga. 1997).
213. 984 F. Supp. 1472 (N.D. Ga. 1997).
214. *See Gross*, 977 F. Supp. at 1472; *ValuJet*, 984 F. Supp. at 1478.
215. *See Gross*, 977 F. Supp. at 1472.
216. *See id.* at 1471 n.4.
217. *See ValuJet*, 984 F. Supp. at 1480.
218. *See Ten Things We Know, supra* note 18. It is predicted that "[w]e will be well into 1998 before . . . any Court of Appeals interprets the pleading standard, into 1999, before we know whether [there is] consensus or disagreement among the twelve Courts of Appeal" as to the proper pleading standard. *See Securities Litigation: Implementation of the Private Securities Litigation Reform Act of 1995 Before the Subcomm. on Fin. and Hazardous Materials of the House Comm. on Commerce, 105th Cong.* (1997) (testimony of Leonard B. Simon, Milberg Weiss Bershad Hynes & Lerach, LLP), *available in* 1997 WL 14152316. If a "Circuit split" emerges among the 12 Courts of Appeals, it is

follow a more stringent pleading standard as favored in the *Silicon Graphics* cases, it is likely that defendants will prevail more often on motions to dismiss and that there will be a decline in the number of federal complaints filed.[219]

Post-Reform Act studies conducted by both the SEC and independent organizations measure the short-term impact on the number of suits filed in federal courts.[220] In the first year following the enactment of the Reform Act, the SEC identified 105 securities cases filed in federal court.[221] Securities Class Action Alert identified this figure as representing a decline from the 153 suits filed in 1993, the 221 suits filed in 1994, and the 158 suits in 1995.[222] A more recent study indicates that the number of suits filed is currently rebounding to, and well within the range of, pre-Reform Act statistics.[223]

Since the enactment of the Reform Act, there also seems to be an apparent migration of securities fraud cases to state courts.[224] The large increase in the number of state court cases filed is best described as a "substitution effect," whereby plaintiffs elect to file suit in state courts to either avoid the federal pleading standard, safe harbor provisions, discovery stays, or notice requirements.[225] In many state courts, plaintiffs do not need a unanimous verdict as they would in the federal system, and thus, plaintiffs can recover on a 9-3 jury vote.[226] In addition to procedural advantages, plaintiffs can also recover on a showing of negligence, as opposed to recklessness or intentional misconduct.[227] However, fluctuations in the number of state or federal court cases filed are not

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very likely that the Supreme Court will "take up this issue." *See id.*

219. *See Ten Things We Know*, *supra* note 18.

220. *See, e.g.*, U.S. SEC, Office of the General Counsel, *Report to the President and the Congress on the First Year of Practice Under the Private Securities Litigation Reform Act*, *in* SAILING IN "SAFE HARBORS": DRAFTING FORWARD-LOOKING DISCLOSURES, at 90-91 (PLI Corp. Law & Practice Course Handbook Series No. 80-0013, 1997) (listing the results from studies conducted by the SEC, Securities Class Action Alert, and the National Economic Research Associates) [hereinafter *Report to the President*].

221. *See id.*

222. *See id.* The decline in the number of suits filed in 1996 can be attributed to the large number of class actions promptly filed in December 1995 to evade key Reform Act provisions. *See* Coffee, Jr., *supra* note 59, at 5.

223. *See What We Know and Don't Know About the Private Securities Litigation Reform Act of 1995 Before the Subcomm. on Fin. and Hazardous Materials of the House Comm. on Commerce* 105th Cong. (1997) (testimony of Michael A. Perino, Stanford Law School) (last modified Oct. 23, 1997) <http://securities.stanford.edu/report/testimony/971021.html> [hereinafter *What We Know and Don't Know*].

224. *See* Levitt, *supra* note 11. Recent figures indicate that there has been a 26% increase in state court litigation. *See* Grundfest & Perino, *supra* note 49.

225. *See* Grundfest & Perino, *supra* note 49.

226. *See Ten Things We Know*, *supra* note 18.

227. *See id.*

necessarily indicative of the Reform Act's overall impact.[228] More importantly, the quality of suits filed has increased as pleadings are more specific and contain more detailed factual allegations.[229] This observation indicates that plaintiffs are taking into account the possibility of a heightened, but unsettled, pleading standard.[230]

The different holdings rendered by federal district courts suggest that either further legislation needs to be enacted, or a decision by a higher court is desperately needed to determine what constitutes scienter for fraud. The need for further clarification is apparent as the circuits struggle within themselves to determine the adequate pleading standard. This need is especially evidenced in both the Ninth and the Second Circuits as present decisions put into doubt past decisions.[231] Thus far, the other federal circuits to confront the pleading standard under the Reform Act are consistently applying either the Second Circuit's standard or a more stringent standard. The dominant and unquestioned trend in the Fifth, the Seventh and the Eleventh Circuits embraces the standard set forth in the Second Circuit.[232] The First and the Third Circuits currently favor the more stringent conscious behavior approach as articulated in *Friedberg*.[233] The Sixth Circuit also favors imposing a heightened pleading standard which either expands rule 9(b) of the Federal Rules of Civil Procedure or requires a strong inference of knowing misrepresentation.[234]

The courts heightening the pleading standard frequently reference the Reform Act's omission of language referring to motive, opportunity, and recklessness to support their position. Can courts correctly assume that because language relating to motive, opportunity, and recklessness has been omitted from the pleading standard, that these factors offer insufficient proof of scienter? This Comment has illustrated how the federal district courts struggle to find meaning in this glaring omission. Frequently, courts also refer to the Reform Act's legislative intent and purpose to support their position and either conclude that the Reform Act did or did not intend to abolish these factors under the Reform Act.[235] The district courts' holdings that the Reform Act intended to heighten the pleading standard for fraud beyond the Second Circuit's standard offer well-founded arguments and explanations, and consequently, higher courts reviewing these decisions will have a difficult time refuting these interpretations. Thus, in the future it is very likely that higher courts will impose a heightened standard. The real question, therefore, becomes whether future courts are willing to support a higher pleading standard, and if so, then just how much more stringent should this standard be?

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228. *See Report to the President, supra* note 220, at 91.
229. *See Levitt, supra* note 10.
230. *See id.*
231. *See supra* notes 49-109, 122-68 and accompanying text discussing the Ninth and the Second Circuits decisions.
232. *See supra* notes 180-85, 190-217 and accompanying text.
233. *See supra* notes 110-21, 169-79 and accompanying text.
234. *See supra* notes 186-89 and accompanying text.
235. *See supra* notes 25-38 and accompanying text.

As noted in this Comment, the opinions in both *Silicon Graphics* cases are very well-reasoned and illustrate the struggles the court embraces as it examines the legislative history, purpose, and language of the Reform Act to conclude that a more stringent pleading standard than the Second Circuit was intended.[236] Nevertheless, such thoughtful reasoning has not deterred criticism.[237] First, if Congress intended for a more stringent rule than motive and opportunity to apply, there is no indication of how much more stringent the new requirement should be or that conscious behavior should be substituted for proof of recklessness as the new element to establish scienter.[238] To counter such criticism, the *Silicon Graphics* court can argue that its holdings are not intended to change the standard for scienter, but instead only specify what must be pleaded in order to properly allege scienter as dictated by the Reform Act.[239] However, this is a "distinction without a difference" because for plaintiffs to effectively plead facts showing conscious behavior, plaintiffs abolish any liability for recklessness as they are forced to plead specific facts and instances of conduct demonstrating fraud.[240] Second, even if conscious behavior was the accepted and required standard, this standard is contrary to other provisions Congress provides in the statutes.[241] Specifically, this problem addresses the language under section 21(D)(g), the proportionate liability provision of the Reform Act, which provides that the standard of liability was not intended to be altered by the Reform Act and also makes distinctions between knowing and non-knowing conduct.[242] Questions arise as to why this distinction is made if the real intent of the Reform Act, as pronounced by the *Silicon Graphics* court, is to abolish recklessness as a standard of liability under section 10(b) and rule 10b-5.[243] The *Silicon Graphics* court addressed and refuted this issue by stating that the proportionate liability provisions apply to the entire Exchange Act, and not simply to the Reform Act amendments.[244]

Regardless of the well-reasoned explanations given by the *Silicon Graphics* court to support its position in both cases, the decisions have not received widespread support. The *Silicon Graphics* cases will always be controversial not because they heighten the pleadings standard, but mainly because they alter the substantive law for the required state of mind to plead securities fraud by

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236. *See supra* notes 63-97 and accompanying text.
237. *See* Coffee, Jr., *supra* note 59, at 5.
238. *See id.*
239. *See id.*
240. *See id.*
241. *See id.*
242. *See id.*
243. *See id.*
244. *See id.*; *Silicon Graphics I*, No. C 96-0393, 1996 WL 664639, at *7 (N.D. Cal. Sept. 25, 1996).

abolishing motive, opportunity, and recklessness as forms of scienter. Consequently, it is not likely that other courts will openly embrace the *Silicon Graphics* approach because it departs too much from traditionally accepted standards and often results in intervention by the SEC.

Instead, note that the SEC is much more receptive to a decision like *Baesa* which raises the pleading standard for fraud while still maintaining that recklessness remains a viable post-Reform Act form of scienter.[245] The *Baesa* holding fits in between the more extreme *Silicon Graphics* view and the various cases which hold that the Second Circuit's standard is still applicable.[246] The *Baesa* decision is more accurately described as a hybrid of the Second Circuit standard and the Reform Act's intent of establishing a more exact pleading standard. In a plain language interpretation of the Reform Act, the *Baesa* court used the actual written language of the Reform Act as a guideline for determining to what extent the Reform Act heightens the pleading standard for securities fraud.[247] Unlike the *Silicon Graphics* court, which placed a substantial value in the language found in footnote twenty-three and the Congressional byplays that accompanied the Reform Act, the *Baesa* court did not allow these factors to govern its decision.[248] The *Baesa* approach seems well-balanced because to allow otherwise would either give too much weight to the language in footnote twenty-three and to Congressional byplays which are too difficult to interpret, or completely disregard the Reform Act's intent of imposing a heightened standard to curb the filing of frivolous lawsuits.

Determining whether motive, opportunity, or recklessness no longer constitute scienter for fraud will be a difficult undertaking for any of the higher courts faced with this issue. Balancing the Reform Act's language, legislative history, and purpose is not an easy task and frequently yields distinct views as evidenced in the different opinions thus far reached by the federal district courts. However, in the future, higher courts confronted with the issue should use the *Baesa* holding as a guideline because *Baesa*'s plain language interpretation of the Reform Act imposes natural limits on the lower courts while still championing the main goal of the Reform Act: to curb the filing of frivolous lawsuits.

LISA A. HERRERA

245. *See supra* text accompanying note 140 (stating that *Baesa* is a more favorable decision for plaintiffs).

246. *See supra* notes 142-68 and accompanying text.

247. *See In re* Baesa Sec. Litig., 969 F. Supp. 238, 242 (S.D.N.Y. 1997).

248. *See id.*